

## Introduction

Commercial real estate has been at the forefront of issues confronting banks in the current cycle, a result of both bank exposure and poor loan performance. In the following, we examine several topics pertaining to commercial real estate, bank exposure and bank distress, namely:

- Commercial real estate values,
- Commercial real estate debt maturities,
- Commercial real estate exposure,
- Loan performance and charge-offs,
- Bank distress, and
- Market conditions and outlook.

## Commercial Real Estate Values

- One of the most important features of the current real estate cycle is the dramatic decline in property values. The most recent figures indicate that commercial property values have fallen by approximately 42% since peaking in late 2007. That is larger than the decline in the early 1990s, when commercial real estate values fell by nearly one-third from 1988 to 1993, and on par with our estimates of the decline during the Depression.
- Recent trends in the Moody's Commercial Property Price Index (CPPI) indicate that prices stopped sliding in late-2009 and have fluctuated somewhat since then. The bottom in the CPPI was reached in August 2010, and has risen by 6.4% through November 2010.
- Prices for shares of publicly traded real estate investment trusts (REITs) have recovered significantly since reaching a cyclical bottom in February 2009, more than doubling in that period. Even with the increase, REIT share prices are approximately 33% below their peak levels in early 2007.
- The rise in REIT share prices and recent positive trends for the CPPI likely indicate that prices will rise further. Still, the decline from previous peaks is substantial and recovery will likely stretch over a protracted period. Our analysis indicates that it took 8 years for prices to recover from the Depression and 10 years to recover from the early 1990s downturn.

## Commercial Real Estate Debt Maturities

- A rising volume of maturing mortgages has put pressure on the commercial real estate debt market, and will continue to do so for several years. By Foresight Analytics estimates, annual maturities reached \$200 billion in 2006 and surpassed \$300 billion in 2009.
- We further estimate that commercial real estate debt maturities will climb to approximately \$350 billion per year between 2011 and 2013. Maturing amounts will

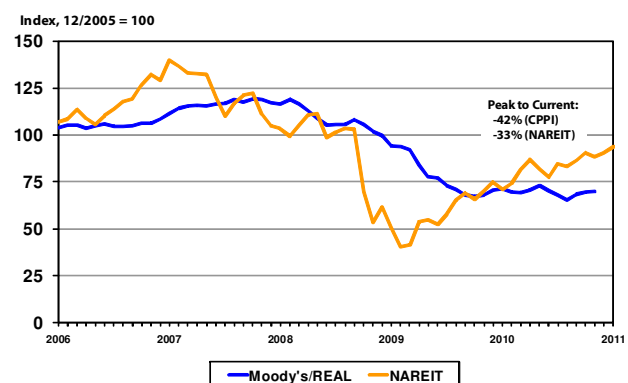
### Commercial Real Estate Bear Markets

#### Major Value Decline – Prospect is a Long Recovery

Period	Decline	Duration	Time to Recover
1929 to 1933	-44%	4 years	8 years
1941 to 1943	-42%	2 years	2 years
1989 to 1993	-32%	4 years	10 years
1999 to 2002	-4%	3 years	2 years
2007 to Present	REITs: -33% Direct: -42%	3 years	?

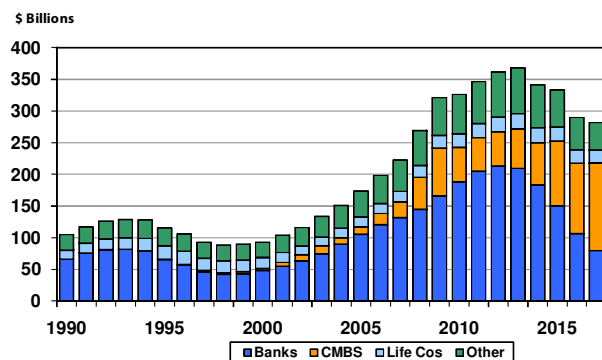
Sources: Foresight Analytics, Moody's, NCREIF, Bureau of Economic Analysis

### Commercial Real Estate Values Moody's/REAL CPPI vs. NAREIT Price Index



Sources: Moody's/MIT, NAREIT, Foresight Analytics

### Commercial Real Estate Debt Maturities Annual Maturities by Lender Type



Sources: Federal Reserve, Foresight Analytics

decline thereafter, but will stay elevated for some time, exceeding \$250 billion annually through 2017.

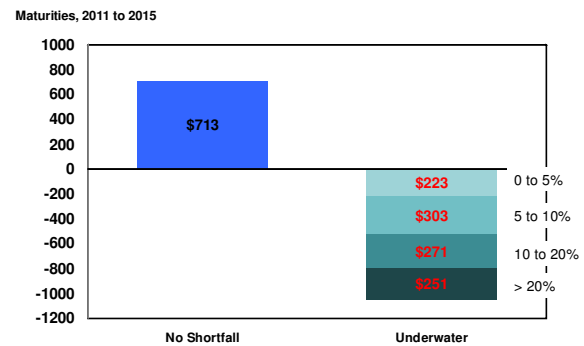
- The rising amount of commercial real estate (CRE) debt maturing is the result of tremendous growth in the market. Commercial real estate debt increased by \$1.8 trillion between 2000 and 2007, more than doubling in size.
- The most rapid growth occurred in 2005, 2006 and 2007, with more than \$300 billion of net growth in each year. The peak growth was reached in 2007, with \$379 billion of net growth.
- We estimate significant refinancing demand from the 2006 and 2007 “boom years” cohorts during the next several years. We are particularly concerned about the ability of these properties to qualify for refinancing, in an environment with lower valuations and lower loan-to-value ratios.
- The combination of lower property values and rising volumes of maturing mortgages has resulted in a large amount of maturing loans that are “underwater” — where the outstanding balance on the loan is more than the value of the property. We estimated that as much as half of the loans maturing in 2011 to 2015 are currently underwater. Of the roughly \$1 trillion of CRE debt that we put in this category, an estimated \$271 billion is underwater by 10% to 20%, and a further \$251 billion is underwater by more than 20%.

### Commercial Real Estate Debt Exposure

- As of 3Q 2010, banks held nearly \$1.7 trillion of commercial real estate debt on their balance sheets — \$1.3 trillion in the form of commercial mortgages (on non-residential and multifamily properties) and \$400 billion in construction & land loans and unsecured loans to finance commercial real estate, such as loans to REITs.
- While large banks — over \$100 billion in assets — hold \$553 billion (one-third) of this debt, smaller banks have a more pronounced reliance on commercial real estate loans. Approximately two-thirds of CRE debt is held by banks with less than \$100 billion in total assets.
- Many banks entered the financial crisis with substantial exposures to commercial real estate<sup>1</sup>. As of 1Q 2007, 2,740 banks and thrifts (31.6% of the total bank

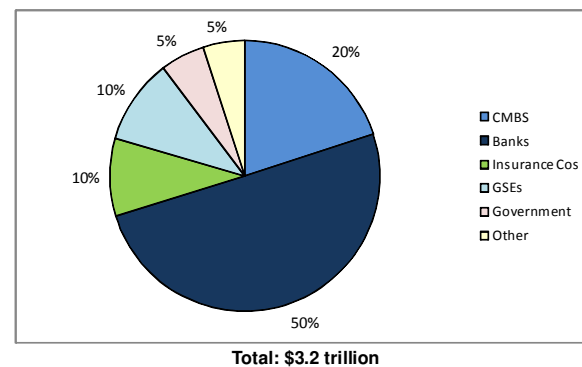
<sup>1</sup> A bank is deemed to have a CRE concentration if either a) construction & land loans outstanding are equal to or greater than 100% of the bank’s total capital, or b) all CRE loans outstanding — construction & land loans, commercial mortgages (excluding owner-occupied properties), multifamily mortgages and unsecured CRE loans — are equal to or greater than 300% of the bank’s total capital.

Underwater Mortgages  
Maturing in 2011 to 2015 by Severity of Value Shortfall



Source: Foresight Analytics

CRE Debt Sources  
As of 3Q 2010



Source: Federal Reserve

CRE Exposure by Size  
Banks & Thrifts, as of 3Q 2010

Size Group, Total Assets	Bank Count	CRE vs. Total Capital	Total (\$ Bn)	Commercial Mortgage*	Construction & Land	Unsecured CRE
>= \$100 Bn	19	70%	\$552.9	\$393.4	\$125.1	\$34.4
\$10 Bn to \$100 Bn	91	116%	\$353.0	\$275.7	\$68.3	\$9.0
\$1 Bn to \$10 Bn	562	264%	\$386.8	\$304.8	\$77.9	\$4.1
\$100 Mn to \$1 Bn	4,415	273%	\$375.8	\$295.3	\$77.7	\$2.8
\$0 to \$100 Mn	2,682	141%	\$26.0	\$20.8	\$4.9	\$0.3
Total	7,769	121%	\$1,694.4	\$1,289.9	\$353.9	\$50.6

\* Includes Owner-Occupied Real Estate and Multifamily Loans.

Sources: FDIC, FFIEC, Foresight Analytics

count) had a commercial real estate concentration. The greatest concentrations were among banks with \$1 to \$10 billion in assets (303 banks or 56% of the size category) and banks with \$100 million to \$1 billion in assets (1,888 banks or 43% of the size category).

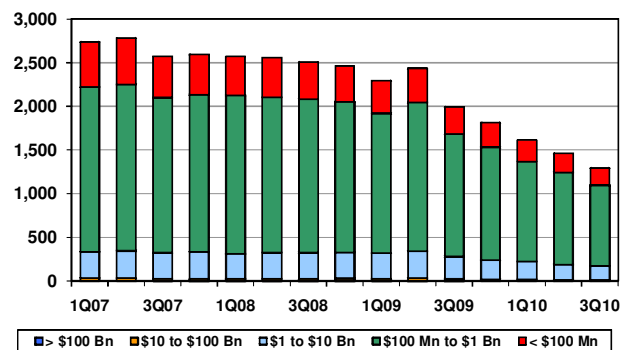
- While their exposure remains substantial, banks have reduced their concentrations in commercial real estate, especially beginning in the second half of 2009. Part of this reduction is the result of rising bank equity capital (from fresh equity issuance and retained earnings) and part is the result of reduced amounts of debt outstanding.
- Construction & land loans outstanding peaked in 1Q 2008 at \$633 billion, falling to \$354 billion as of 3Q 2010, a \$279 billion decline.
- Commercial mortgages outstanding (including multifamily) peaked in 2Q 2009 at \$1.31 trillion, falling to \$1.29 trillion as of 3Q 2010, an \$18 billion decline.
- Unsecured CRE loans have contracted by \$20 billion since peaking at \$70 billion in 4Q 2008.
- The number and proportion of banks with CRE concentrations has fallen significantly since 2007. As of 3Q 2010, 1,296 banks and thrifts (17% of the total) had a CRE concentration, a decline of 1,444 from 1Q 2007. CRE Concentrations have fallen for all size groups, but remain highest among banks in the \$1 to \$10 billion assets (161 banks, 29% of the total for the size group) and \$100 million to \$1 billion (926 banks, 21% of the total for the size group) total asset size ranges.
- Banks that received CPP funds from TARP are more likely to have commercial real estate concentrations than non-CPP recipients. We have tabulated CRE concentration figures for bank and thrift subsidiaries of firms that received CPP investments — including banks that have repaid the CPP funds — with the result that as of 3Q 2010, 32% of the CPP recipients' subsidiaries had CRE concentrations, compared with 15% for non-CPP recipients' subsidiaries. For banks in the \$1 billion to \$10 billion and \$100 million to \$1 billion asset size ranges, the CPP recipients' ratios were 36% and 35%, respectively, compared to 24% and 19%, respectively, for non-CPP recipients.

## CRE Loan Performance

- Delinquency rates on commercial real estate have surged during the downturn in commercial real estate.
- Construction and Land Loans have been the worst performing CRE segment - with delinquency rates reaching 19.7% in 1Q 2010, up from lows in the 1% range during 2004 to 2006. The peak delinquency rate

CRE Concentrations  
By Bank Size

Number of Banks/Thrifts with CRE Concentration\*



\* CRE Loans (excluding Owner-Occupied Mortgages).

Sources: Call Reports, FDIC, Foresight Analytics

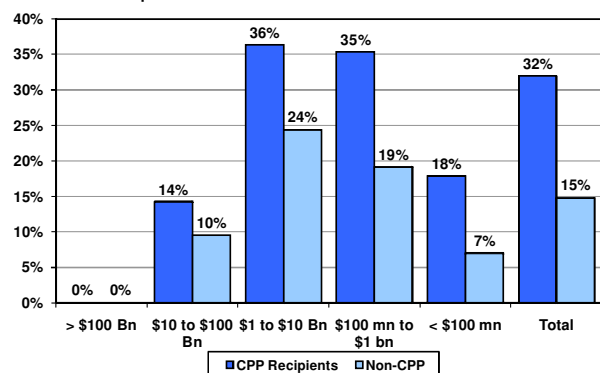
CRE Concentrations  
Banks & Thrifts, 1Q 2007 and 3Q 2010

Size Group, Total Assets	1Q 2007		3Q 2010		Change	
	Number of Banks	% of Size Group	Number of Banks	% of Size Group	Number of Banks	% of Size Group
>= \$100 Bn	4	29%	-	0%	(4)	-29%
\$10 Bn to \$100 Bn	28	27%	11	12%	(17)	-15%
\$1 Bn to \$10 Bn	303	56%	161	29%	(142)	-27%
\$100 Mn to \$1 Bn	1,888	43%	926	21%	(962)	-22%
\$0 to \$100 Mn	517	14%	198	7%	(319)	-7%
Total	2,740	32%	1,296	17%	(1,444)	-15%

Sources: FDIC, FFIEC, Foresight Analytics

CRE Concentrations  
as of 3Q 2010, CPP Recipients and Non-CPP Recipients

% of Banks in Group

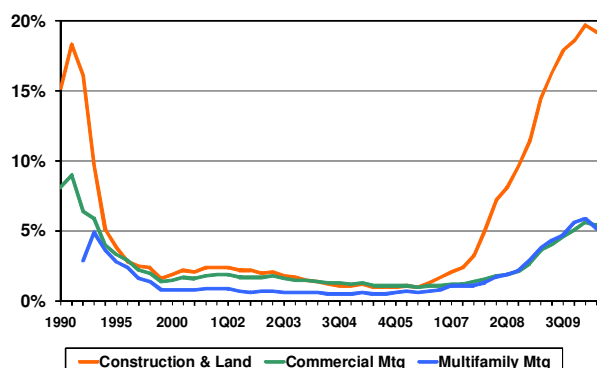


Sources: FinancialStability.gov, FDIC, Federal Reserve, Foresight Analytics

of 19.7% surpasses the previous peak rate of 18.3% (estimated) in 1991, during the height of the early 1990s commercial real estate downturn.

- Our estimates indicate that residential construction has performed the worst within the construction segment, with single family construction delinquencies reaching nearly 30% and condominium construction reaching nearly 45%.
- Commercial real estate construction delinquencies have also risen, per our estimates, to the 12% to 15% range during the first half of 2010.
- Construction delinquency rates have declined since 1Q 2010, as banks have worked through problem loans.
- Delinquency rates on commercial mortgages — both non-residential and multifamily — have risen substantially during the current cycle, reaching 5.5% and 5.7%, respectively, as of 3Q 2010. These delinquency rates were approximately 1% as of 4Q 2006, prior to the onset of the commercial real estate downturn.
- Our early estimates for 4Q 2010 indicate a further slight decline in the commercial mortgage delinquency rates, though a substantial recovery will likely require stronger economic growth and rising demand for space.
- Commercial real estate has accounted for an estimated \$97 billion of bank charge-offs during the 2007 to 2010 period. We estimate \$35.9 billion in CRE charge-offs for banks during 2010 (full-year figures will be available in late February), down slightly from \$37.9 billion in 2009.
- For banks of all sizes, CRE charge-offs accounted for approximately 19% of all charge-offs during 2007 to 2010.
- For banks under \$10 billion in assets, the proportion that CRE comprised was greater, amounting to 53% and 51%, respectively, for banks in the \$1 to \$10 billion and \$100 million to \$1 billion total asset size ranges.
- Charge-offs on construction and land loans accounted for approximately two-thirds of CRE charge-offs, across most bank size groups.
- Income yields on CRE loans have fallen since 2006 and 2007.
- We estimate that yields on construction and land loans have fallen to slightly below 3% as of 3Q 2010, down from recent highs in the upper-8% range in the first half of 2007. These loans are typically floating rate and falling short-term yield benchmarks have resulted in declining yields on these loans.
- We estimate that yields on commercial mortgages have fallen, though not as precipitously. Within the commercial mortgage segment there is a greater blend of fixed rate and floating rate debt. On a blended

Commercial Real Estate Delinquencies\*  
Percent of Amount Outstanding



\* Loans 30+ Days Past Due.

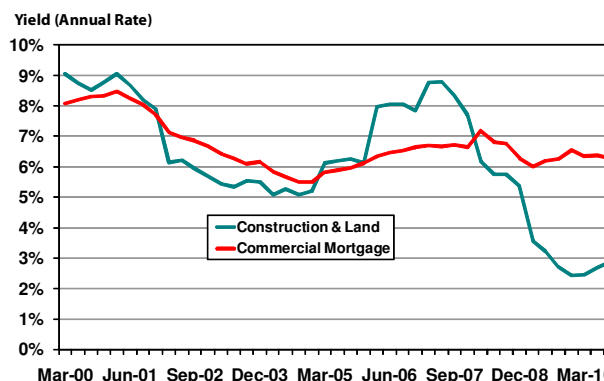
Sources: FDIC, Federal Reserve, Foresight Analytics

CRE Charge-Offs by Bank Size  
Commercial Banks

Size Group, Total Assets	2007	2008	2009	2010e	Share of Total Charge-Offs, 2007 to 2010e		
					CRE Total	Construction	Commercial Mortgage
>= \$100 Bn	\$0.4	\$3.8	\$11.1	\$13.3	9.2%	6.1%	3.1%
\$10 to \$100 Bn	\$1.1	\$7.1	\$10.3	\$9.2	21.4%	15.0%	6.4%
\$1 to \$10 Bn	\$1.1	\$5.4	\$10.3	\$8.5	52.7%	37.2%	15.5%
\$100 Mn to \$1 Bn	\$0.8	\$3.2	\$5.8	\$4.6	51.1%	35.2%	16.0%
\$0 to \$100 Mn	\$0.1	\$0.2	\$0.4	\$0.3	44.4%	24.2%	20.3%
Total	\$3.5	\$19.7	\$37.9	\$35.9	18.8%	12.9%	5.9%

Sources: FDIC, Foresight Analytics

CRE Loan Yields  
By Loan Type



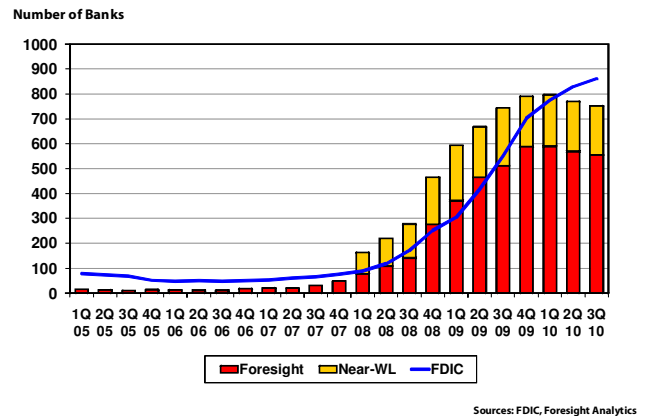
Source: Call Reports/TFRs, Foresight Analytics

basis, our estimates indicate these yields have fallen to the low 6% range, down from the 7%+ range reached in 2007.

## Bank Distress

- With the economic and real estate downturn, bank distress has increased. As of 3Q 2010, 860 banks were on the FDIC's Problem List, up from a cyclical low of 47 in 3Q 2006. By comparison, the number of banks on the Foresight Analytics combined Watch List and Near-Watch List was 753 as of 3Q 2010.
- Nonperforming CRE loans have been the largest problem loan type for banks on the Foresight Analytics Watch List.
- For 81% of the banks on our Watch List, CRE loans account for most of the banks' nonperforming (or defaulted) loans.
- For 262 (47%) of the Watch List banks, construction and land loans were the largest source of nonperforming loans. While construction and land loans remain the single largest problem loan type, the proportion for Watch List banks has been declining during the last several quarters.
- Nonperforming commercial mortgages were the largest problem loan type for 190 (34%) of the banks on our Watch List. This figure has been rising in both absolute terms and as a proportion of the Watch List for the last two years.
- Bank failures rose to 157 in 2010, up from 140 in 2009 and 25 in 2008.
- The pace of closures seems to have moderated recently. In 4Q 2010, there were 30 closures, a noticeable reduction from the 40 to 50 per quarter during the previous five quarters. In the first month of 2011, 11 banks were closed.
- The number of distressed banks remains high, however, and we expect more bank failures during 2011.

Bank Distress  
FDIC Problem Institutions vs. Foresight Watch List



Sources: FDIC, Foresight Analytics

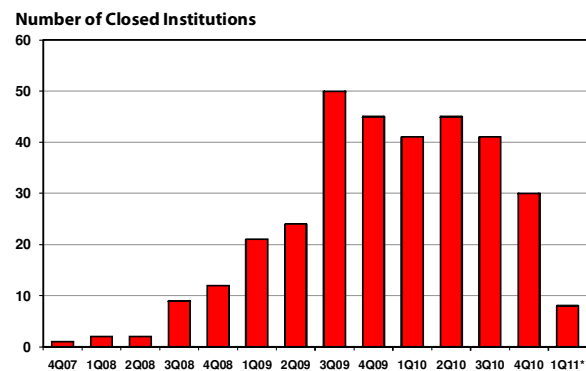
Sources of Distress  
Top Source of Nonperforming Loans for Watch List

Loan Type	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10
Construction & Land	229	278	303	327	311	271	262
Commercial Mortgage*	64	88	117	146	164	179	190
Residential Mortgage	65	75	76	95	84	93	77
Other	13	25	16	26	31	27	27
Total	371	466	512	594	590	570	556
Shares:							
Construction & Land	62%	60%	59%	55%	53%	48%	47%
Commercial Mortgage*	17%	19%	23%	25%	28%	31%	34%
Residential Mortgage	18%	16%	15%	16%	14%	16%	14%
Other	4%	5%	3%	4%	5%	5%	5%

\* Includes Multifamily.

Source: Foresight Analytics

Bank Distress  
Bank Failures per Quarter — Current Cycle



\* Through 1/28/11

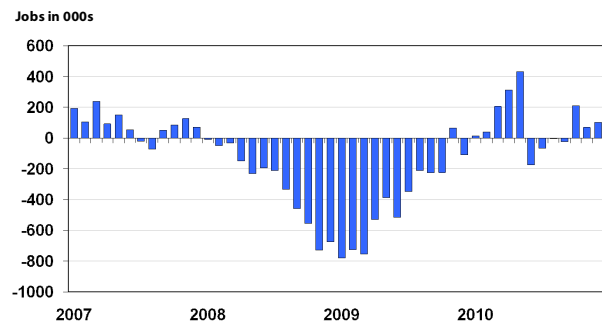
Source: FDIC



## Market Conditions and Outlook

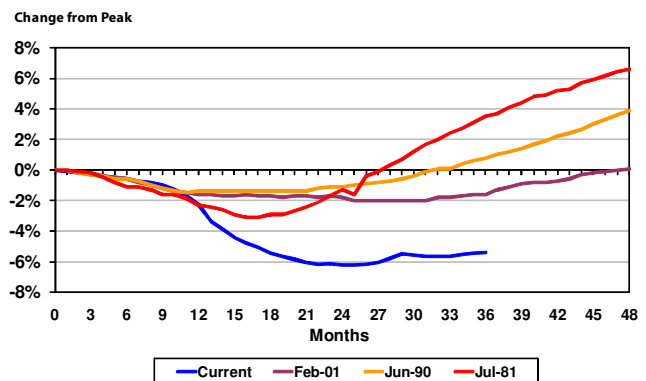
- Economic and real estate market conditions are improving, albeit slowly.
- Office vacancy rates stabilized during 2010 — in the mid-teens for CBD office markets and high teens for suburban markets, after having risen approximately 5 percentage points from recent lows in 2007. Rents have also stabilized at levels approximately 10% lower than 2007 levels. The combined impact of higher vacancy rates and lower rents has been a drop in net operating income of 15%. Other commercial real estate sectors have been hit by similar downturns in occupancy and rents, with the lodging sector experiencing the greatest volatility.
- Job growth turned positive in 2010, with 1.1 million jobs added for the year. While this is a welcome trend, the magnitude of job losses remains great, at 7.4 million jobs lost since December 2007. Moreover, the pattern of job growth has been uneven, with slower growth following the surge in jobs in early 2010.
- We estimate that 333,000 office sector jobs were created during 2010. This follows the loss of 2.2 million office jobs during 2007 to 2009, with the result that office jobs have declined a net 1.9 million since 2007.
- Liquidity has also been returning to the commercial real estate market. This has been most notable in the CMBS segment, where \$11.6 billion of new issuance occurred in 2010. Trepp, LLC expects this trend to continue, with a forecasted \$50 billion of issuance during 2011.
- Spreads on new originations of commercial mortgages have recovered substantially since the worst of the crisis in late-2008 and early-2009. According to the TREPP-i pricing index, spreads on new commercial mortgages have fallen from 550+ basis points at the worst part of the crisis, to current spreads in the 225 to 250 basis point range. Underwriting remains conservative, however, with these spreads available for loans with moderate leverage in the 50% to 59% loan-to-value range.
- Our outlook for the commercial real estate market includes:
  - A prolonged recovery. An improving economy will lead to stronger supply and demand fundamentals for real estate, but the pace of recovery is expected to remain slow.
  - Gradual improvement in loan delinquency rates. Lenders will continue to reduce nonperforming loan balances — through note sales and workouts on the one hand, and improving market conditions on the other — but this process looks likely to last

Employment Growth  
Monthly Change in Jobs, Seasonally Adjusted



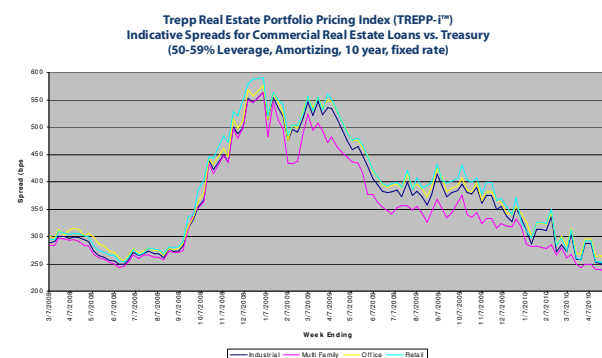
Source: Bureau of Labor Statistics

Job Losses  
Current vs. Previous Cycles



Sources: Bureau of Labor Statistics, Foresight Analytics

Spreads for New Commercial Real Estate Loans



Compiled from a survey of institutional lenders. Copyright, 2010, Trepp, LLC, all rights reserved.

Source: Trepp, LLC

several more quarters.

- Unless real estate values rebound substantially, distress will continue to materialize over the next several years, despite an overall improvement in delinquencies and defaults. Depressed values will weigh on the market as underwater loans mature and fail to qualify for fresh financing. We expect this volume to decline over time, as values increase, but the significant dollar amount of underwater maturities we estimate leads us to believe that problem loans will continue to emerge for several years to come.
- Continued high demand for refinancing from loans originated during the commercial real estate debt boom of the 2000s. As a result, the commercial real estate debt market will post modest real — inflation-adjusted — growth over the next decade. Growth in the market will more closely resemble the 1990s, when annual growth was 0.8% in real terms, rather than 2000 to 2008, when annual real growth was 9.4%.

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### **About Foresight**

Foresight Analytics is a division of Trepp that provides analysis and forecasting for the real estate and banking industries. The company focuses on commercial and residential real estate market fundamentals and bank lending. Clients are mainly institutional investors, lenders and developers.

### **About Trepp**

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